



ACCOUNTING

AN INTRODUCTION

ATRILL • MCLANEY • CONG • O'LEARY



EDITION

9

FULL CONTENTS

About the Australian authors	xvi
Preface	xvii
For students: How do I use this text?	xxii
Educator resources	xxiv
Reviewers	xxv

CHAPTER 1

Introduction to accounting	1
.....	
Nature and role of accounting	3
Accounting as a service function	4
Costs and benefits of accounting information	5
Accounting as an information system	6
Users of accounting information	7
Financial and management accounting	10
What is the financial objective of a business?	12
Stakeholder theory	13
Balancing risk and return	15
The main financial reports—an overview	16
Financial accounting	16
The three main statements—an illustration	17
Management accounting	20
Business and accounting	22
What kinds of business ownership exist?	22
Sole proprietorship	22
Partnership	24
Limited company	25
How are businesses managed?	27
Not-for-profit organisations	29
The changing landscape of business and accounting	31
Technology development and accounting	32
Ethics and ethical behaviour in business	33
The role of regulators	36
How useful is accounting information?	38
Why do I need to know anything about accounting and finance?	39
Summary	41
References	43
Discussion questions	43
Case study	44
Concept check answers	46
Solutions to activities	46

CHAPTER 2

Measuring and reporting financial position	49
.....	
Nature and purpose of the statement of financial position	50
Assets	50
Claims against the assets	52
The accounting equation	54
The effect of trading operations on the statement of financial position	56
The classification of assets and claims	61
Classifying assets	62
Classifying claims	64
Classifying owners' equity	64
Formats for the statement of financial position	66
Horizontal format	66
Vertical or narrative format	66
Financial position at a point in time	69
Factors influencing the form and content of the financial reports	70
Conventional accounting practice	70
Business entity convention	71
Historic cost convention	71
Prudence (or conservatism) convention	72
Going concern (or continuity) convention	73
Dual-aspect convention	73
Money measurement convention	73
Stable monetary unit convention	76
Valuing assets	76
Valuing non-current assets	77
Fair values	77
The impairment of assets	78
Usefulness of the statement of financial position	81
Statement of financial position deficiencies	84
Summary	87
Discussion questions	88
Application exercises	89
Case study	93
Concept check answers	95
Solutions to activities	95

CHAPTER 3**Measuring and reporting financial performance 101**

The statement of financial performance—its nature and purpose, and its relationship with the statement of financial position 102

Nature and purpose of the statement of financial performance 102

Relationship between the two statements 104

The stock approach to calculating profit 105

The format of the income statement 106

Key terms 107

Classifying expenses 108

The reporting period 109

Profit measurement and the recognition of revenues and expenses 110

Recognising revenue 110

Revenue recognition and cash receipts 111

Recognising revenue over time 112

Revenue recognition in practice 114

Recognising expenses 114

Accruals and prepayments in practice 117

Profit, cash and accruals accounting—a review 118

Profit measurement and the calculation of depreciation 119

Calculating depreciation 120

1. The cost (or fair value) of the asset 120

2. The useful life of the asset 121

3. Estimated residual value (disposal value) 121

4. Depreciation method 121

Impact of depreciation method on profit 124

Selecting a depreciation method 125

Impairment and depreciation 126

Depreciation and the replacement of fixed assets 126

Depreciation and judgement 126

Profit measurement and the valuation of inventory 128

What is inventory? 128

What is the cost of inventory? 128

What is the basis for transferring the inventory cost to cost of sales? 128

Inventory recording systems 131

The net realisable value of inventory 132

Profit measurement and the problem of bad and doubtful debts 133

The traditional approach 133

The impairment of assets approach 136

Preparing an income statement from relevant financial information 138**Uses and usefulness of the income statement 140**

Summary 148

Discussion questions 149

Application exercises 150

Case study 155

Concept check answers 157

Solutions to activities 157

CHAPTER 4**Introduction to limited companies 163****The main features of companies 164**

Legal nature 164

Unlimited (perpetual) life 164

Limited liability 165

Legal safeguards 165

Public and proprietary (private) companies 166

Transferring share ownership—the role of the stock exchange 167

Separation of ownership and management 168

Extensive regulation 168

Advantages and disadvantages of the company entity structure 171

Equity and borrowings in a company context 174

Equity/capital (owners' claim) of limited companies 174

Reserves 177

Bonus shares 178

Raising share capital 179

Borrowings 180

Restrictions on the rights of shareholders to make drawings or reductions of capital 181**The main financial statements 186**

The income statement 187

The statement of financial position 188

Dividends 188

Summary 190

Discussion questions 191

Application exercises 192

Case study 197

Concept check answers 201

Solutions to activities 201

CHAPTER 5**Regulatory framework for companies 204**

The directors' duty to account—the role of company law (*Corporations Act*) 205

Auditors 206

Sources of rules and regulation 210

Sources of accounting rules 210

Corporate governance 212

ASX framework for corporate governance	212
Other lessons for corporate governance	215
Presentation of published financial statements	218
Statement of financial position	218
Statement of comprehensive income	219
Statement of changes in equity	222
Statement of cash flows	223
Notes	223
Accounting for groups of companies	224
Preparation of consolidated accounts	225
Summary	230
References	230
Discussion questions	231
Application exercises	232
Case study	236
Concept check answers	238
Solutions to activities	238

CHAPTER 6

Measuring and reporting cash flows	242
.....	
The importance of cash and cash flow	243
The statement of cash flows	247
Typical cash flows from the different activities	249
Preparation of the statement of cash flows—a simple example	252
Deducing cash flows from operating activities (direct method)	252
Deducing cash flows from investing activities	255
Deducing cash flows from financing activities	255
The complete statement of cash flows for Example 6.1	256
Indirect method for determining cash flow from operating activities	260
How the indirect method works	261
Usefulness of the indirect method	263
The indirect method in practice	263
Some complexities in statement preparation	266
The investing section	266
The financing section	267
What does the statement of cash flows tell us?	270
Summary	273
Discussion questions	274
Application exercises	275
Case study	281
Concept check answers	284
Solutions to activities	285

CHAPTER 7

Corporate social responsibility and sustainability reporting	290
.....	
Social, environmental and governance issues in accounting	291
Stakeholder concept	291
Legitimacy theory	293
Social responsibility in practice	293
Corporate social responsibility (CSR) and sustainable development—what do they mean?	297
Ceres and sustainability	298
United Nations Sustainability Development Goals and carbon-neutral growth	299
Development of reporting for corporate social responsibility and sustainable development	302
The Global Reporting Initiative (GRI)	305
Background and development of the GRI guidelines	306
Current position—the GRI Standards	306
Brief summary of the GRI Standards	307
The GRI Standards in practice	309
Integrated reporting	312
Integrated reporting guiding principles	313
Integrated reporting and value creation over time	313
International Sustainability Standards Board and Sustainability Accounting Standards Board	316
Sustainability Accounting Standards Board (SASB)	316
SASB Standards, GRI Standards and integration	316
International Sustainability Standards Board (ISSB)	317
Assessment of corporate responsibility and sustainability reporting	318
The current status of sustainability accounting	318
Environmental and social risk management	320
Summary	324
References	325
Discussion questions	326
Application exercises	327
Case study	328
Concept check answers	330
Solutions to activities	330

CHAPTER 8**Analysis and interpretation of financial statements 332****Financial ratios 333**

Financial ratio classification 333

The need for comparison 334

The key steps in financial ratio analysis 335

Example 8.1 data for ratio calculation 336

A brief overview of our example 338

Profitability ratios 339Return on ordinary shareholders' funds (ROSF)
(also known as 'return on equity (ROE)') 339

Return on capital employed (ROCE) 340

Operating profit margin 342

Gross profit margin 342

Profitability ratios in practice 343

Efficiency ratios 344

Average inventories turnover period 345

Average settlement period for accounts
receivable (debtors) 345Average settlement period for accounts
payable (creditors) 346

Sales revenue to capital employed 346

Sales revenue per employee 347

Alternative formats 347

Efficiency ratios in practice 348

The relationship between profitability
and efficiency 348**Liquidity ratios 351**

Current ratio 351

Acid test ratio 352

Liquidity ratios in practice 352

Financial gearing (leverage) ratios 354

Gearing ratio 356

Interest cover ratio (times interest earned) 357

Gearing ratios in practice 357

An aside on personal debt 359

Investment ratios 360

Dividend payout ratio 360

Dividend yield ratio 361

Earnings per share ratio 362

Price/earnings ratio 362

Investment ratios in practice 363

Other aspects of ratio analysis 365

Trend analysis 365

Index or percentage analysis 366

Ratios and prediction models 367

Limitations of ratio analysis 367

Summary 372**References 374***Discussion questions 374**Application exercises 375**Case study 381**Concept check answers 381**Solutions to activities 383**Financial accounting: capstone case 1 387***CHAPTER 9****Cost–volume–profit analysis and relevant costing 391****The behaviour of costs 392**

Fixed costs 392

Variable costs 393

Semi-fixed (semi-variable) costs 394

Break-even analysis 397**Contribution 401**

Calculating the break-even point 401

Profit–volume (PV) charts 402

Margin of safety 403

Operating gearing 404

Weaknesses of break-even analysis 406

Other aspects of break-even analysis 408

Use of break-even analysis in practice 410

Relevant cost, outlay cost and opportunity cost 412**Marginal analysis/relevant costing 415**

Accepting/rejecting special contracts 416

The most efficient use of scarce resources 416

Make or buy decisions 417

Closing or continuing a section or
department 419**Summary 423***Discussion questions 423**Application exercises 425**Case study 429**Concept check answers 430**Solutions to activities 431***CHAPTER 10****Costing 434****The nature of full costing 435****Deriving full costs in a single or multi-product (or service) operation 437**

Single-product businesses 437

Multi-product operations 438

Job costing 439

Full/absorption costing and the behaviour
of costs 440

Job costing: a worked example 443

Selecting a basis for charging overheads 444

Segmenting the overheads	447	Limitations of the traditional approach to control	514
Dealing with overheads on a departmental (cost centre) basis	448	General limitations concerning budgeting systems	514
Batch costing	451	Behavioural aspects of budgetary control	515
Other aspects of full costing	452	Beyond Budgeting (BB)	516
Activity-based costing (ABC)	453	Overall review	519
Costing and pricing: the traditional way	453	Summary	521
Costing and pricing: the new environment	454	References	521
An alternative approach to full costing	455	Discussion questions	522
ABC contrasted with the traditional approach	455	Application exercises	523
Attributing overheads using ABC	457	Case study	529
Benefits of ABC	458	Concept check answers	531
Criticisms of ABC	462	Solutions to activities	531
Uses and criticisms of full costing	464		
Uses of full cost information	464		
Criticisms of full costing	465		
Summary	470		
References	471		
Discussion questions	471		
Application exercises	472		
Case study	478		
Concept check answers	480		
Solutions to activities	480		
CHAPTER 11		CHAPTER 12	
Budgeting	483	Capital investment decisions	535
.....
Planning and control	484	Features of investment decisions and associated appraisal methods	536
Corporate objectives, long-term plans and budgets—their relationship	484	The nature of investment decisions	536
Exercising control	485	Methods of investment appraisal	536
Budgets and forecasts	486	Accounting rate of return (ARR)	539
Time horizons of plans and budgets	486	ARR and ROCE	540
Limiting factors	487	Problems with ARR	541
The interrelationship of various budgets	487	Payback period (PP)	543
The budget-setting process	488	Problems with PP	544
Incremental and zero-based budgeting	489	Net present value (NPV)	546
The uses of budgets	491	Interest lost	547
Non-financial measures in budgeting	492	Inflation	547
The extent to which budgets are prepared	492	Risk	548
Preparing the cash budget	494	Actions of a logical investor	548
Preparing other budgets	498	Worked example	549
Using budgets for control	501	The use of discount (present value) tables	551
Budgetary control—comparing actual performance with the budget	501	The discount rate and the cost of capital	552
Flexing the budget	504	Determining the weighted average cost of capital (WACC)	553
Variance analysis—more detail	507	Why NPV is superior to ARR and PP	554
Standard quantities and costs	510	Discounted payback	555
Reasons for adverse variances	510	Internal rate of return (IRR)	556
Investigating variances	510	Problems with IRR	560
Necessary conditions for effective budgetary control	513	Some practical points	563
		The basis of the cash flow calculations	563
		More practical points	564
		Investment appraisal in practice	567
		Methods used	567
		Investment appraisal and planning systems	568
		Integration with planning systems and decision-making	571
		Risk and uncertainty	571
		Summary	573
		Discussion questions	575

<i>Application exercises</i>	576
<i>Case study</i>	581
<i>Concept check answers</i>	582
<i>Solutions to activities</i>	582
<i>Appendix 12.1: Present value and annuity tables</i>	587

CHAPTER 13

The management of working capital	589
.....	
The nature and purpose of working capital	590
The importance of managing working capital	591
The management of inventories	594
Budgets of future demand	595
Financial ratios	595
Recording and reordering systems	595
Levels of control	597
Stock/inventory management models	598
The management of accounts receivable (debtors)	603
Which customers should receive credit, and how much should they be offered?	604
Length of credit period	605
An alternative approach to evaluating the credit decision	607
Cash discounts (early settlement)	607
Collection policies	608
The management of cash	612
How much cash should be held?	612
Statements of cash flows/budgets and the management of cash	614
Operating cash cycle (OCC)	614
Cash transmission	616
Bank overdrafts	617
The management of accounts payable (creditors)	618
Taking advantage of cash discounts	618
Controlling accounts payable	619
<i>Summary</i>	622
<i>References</i>	623
<i>Discussion questions</i>	623
<i>Application exercises</i>	624
<i>Case study</i>	628
<i>Concept check answers</i>	629
<i>Solutions to activities</i>	630

CHAPTER 14

Financing the business	633
.....	
Sources of finance	634
Internal sources of finance	634

Internal sources of long-term finance—retained earnings (profits)	634
Internal sources of short-term finance	635
External sources of finance	637
External sources of long-term finance	637
Ordinary shares	637
Preference shares	638
Borrowings	639
Finance leases, and sale and lease-back arrangements	644
Hire purchase	645
Securitisation	647
External sources of short-term finance	648
Bank overdrafts	648
Debt factoring	648
Invoice discounting	649
Supply chain finance (or reverse factoring)	649
Funding typically associated with smaller businesses	651
Long-term vs short-term borrowing	652
Gearing and the long-term financing decision	654
Raising long-term equity finance	658
The role of the Australian Securities Exchange	658
Methods for issuing shares	659
Rights issues	660
Dividend reinvestment plans	662
Offer for sale	663
Public issue	663
Private placing	663
Alternative sources of long-term finance for small businesses	664
Venture capital	665
Private equity groups	665
Business angels	667
<i>Summary</i>	669
<i>References</i>	670
<i>Discussion questions</i>	670
<i>Application exercises</i>	671
<i>Case study</i>	678
<i>Concept check answers</i>	679
<i>Solutions to activities</i>	679
<i>Management accounting: Capstone case 2</i>	681
Glossary	683
Index	691

Online topics

Additional Topic 1: Recording transactions—the journal and ledger accounts
Additional Topic 2: Accounting systems and internal control